KNIGHT CAPITAL GROUP, INC.
Form 10-K
February 29, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007**

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

001-14223

Commission File Number

KNIGHT CAPITAL GROUP, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

22-3689303

(I.R.S. Employer Identification Number)

545 Washington Boulevard, Jersey City, NJ 07310

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (201) 222-9400

Securities registered pursuant to Section 12(b) of the Act:

Class A Common Stock, $0.01 par value

Securities registered pursuant to Section 12(g) of the Act:

None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2) Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The aggregate market value of the Class A Common Stock held by nonaffiliates of the Registrant was approximately $1.38 billion at June 29, 2007 based upon the closing price for shares of the Registrant s Class A Common Stock as reported by the NASDAQ Global Select Market on that date. For purposes of this calculation, affiliates are considered to be officers, directors and holders of 10% or more of the outstanding common stock of the Registrant.

At February 27, 2008 the number of shares outstanding of the Registrant s Class A Common Stock was 94,588,893 and there were no shares outstanding of the Registrant s Class B Common Stock as of such date.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement relating to the Company s 2008 Annual Meeting of Stockholders to be filed hereafter (incorporated, in part, into Part III hereof).

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KNIGHT CAPITAL GROUP, INC.

FORM 10-K ANNUAL REPORT

For the Year Ended December 31, 2007

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FORWARD LOOKING STATEMENTS

Certain statements contained in this Annual Report on Form 10-K, including without limitation, those under Legal Proceedings in Part I, Item 3, Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 (MD&A), and Quantitative and Qualitative Disclosures About Market Risk in Part II, Item 7A, and the documents incorporated by reference may constitute forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not historical facts and are based on current expectations, estimates and projections about the Company s industry, management s beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. Accordingly, readers are cautioned that any such forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict including, without limitation, risks associated with the costs, integration, performance and operation of businesses recently acquired, or that may be acquired in the future, by the Company. Since such statements involve risks and uncertainties, the actual results and performance of the Company may turn out to be materially different from the results expressed or implied by such forward-looking statements. Given these uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. Unless otherwise required by law, the Company also disclaims any obligation to update its view of any such risks or uncertainties or to announce publicly the result of any revisions to the forward-looking statements made in this report. Readers should carefully review the risks and uncertainties disclosed in the Company s reports with the U.S. Securities and Exchange Commission (SEC), including those detailed under Certain Factors Affecting Results of Operations in MD&A and in Risk Factors in Part I, Item 1A herein, and in other reports or documents the Company files with, or furnishes from time to time to the SEC. This discussion should be read in conjunction with the Company s Consolidated Financial Statements and the Notes thereto contained in this report.

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PART I

Item 1. *Business*

Overview

Knight Capital Group, Inc., a Delaware corporation (collectively with its subsidiaries, Knight or the Company), is a leading financial services firm that provides electronic and voice trade execution services to the capital markets across multiple asset classes for buy-side, sell-side and corporate clients, and asset management for institutions and private clients.

The Company was organized in January 2000 as the successor to the business of Knight/Trimark Group, Inc. (the Predecessor). The Predecessor was organized in April 1998 as the successor to the business of Roundtable Partners, LLC, which was formed in March 1995. In May 2000, the Company changed its name from Knight/Trimark Group, Inc. to Knight Trading Group, Inc., and in May 2005 the Company further changed its name to Knight Capital Group, Inc. Our corporate headquarters are located at 545 Washington Boulevard, Jersey City, New Jersey 07310. Our telephone number is (201) 222-9400.

Financial information concerning our business segments for each of 2007, 2006 and 2005, respectively, is set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 and the Consolidated Financial Statements and Notes thereto located in Part II, Item 8 entitled Financial Statements and Supplementary Data.

Available Information

Our Internet address is www.knight.com. We make available free of charge, on or through the Our Firm Investor Center section of our corporate web site under SEC Filings , annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Forms 3, 4 and 5 filed on behalf of directors and executive officers, and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, and our proxy statements as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Also posted on our corporate web site is our Code of Business Conduct and Ethics (the Code) governing our directors, officers and employees. Within the time period required by the SEC, we will post on our corporate web site any amendments and waivers to such Code applicable to our executive officers and directors, as defined in the Code.

Our Board of Directors (the Board) has standing Finance and Audit, Compensation and Nominating and Corporate Governance committees. Each of these Board committees has a written charter approved by the Board. Our Board has also adopted a set of Corporate Governance Guidelines. Copies of each committee charter, along with the Corporate Governance Guidelines, are posted on the Company s web site. None of the information on our corporate web site is incorporated by reference into this report.

All of the above materials are also available in print, without charge, to any person who requests them by writing or telephoning:

Knight Capital Group, Inc.

Communications, Marketing and Investor Relations

545 Washington Boulevard

Jersey City, NJ 07310

(201) 222-9400

Unless otherwise indicated, references to the Company, Knight, We, Us, or Our shall mean Knight Capital Group, Inc. and its subsidiaries.

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Business Segments

The Company has two operating business segments, Asset Management and Global Markets, as well as a Corporate segment.

Asset Management Our Asset Management business, Deephaven Capital Management (Deephaven), is a global, multi-strategy alternative investment manager focused on delivering attractive risk-adjusted returns with low correlation to the broader markets for institutions and private clients. Assets under management were $3.9 billion as of December 31, 2007, down from $4.2 billion as of December 31, 2006.

Global Markets Our Global Markets business provides market access and trade execution services in nearly every U.S. equity security and a large number of international securities, futures, options, foreign exchange and fixed income. We offer high quality trade executions through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support alpha creation and capital formation.

The Company s Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and our corporate investment as a limited partner or non-managing member in funds managed by Deephaven. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors fees, investor and public relations expenses and directors and officers insurance.

In December 2004, the Company completed the sale of one of its business segments, Derivative Markets, to Citigroup Financial Products Inc. In accordance with generally accepted accounting principles (GAAP), the results of this segment have been included within discontinued operations. For a further discussion of the sale of the Company s Derivative Markets business, see Footnote 16 Discontinued Operations included in Part II, Item 8 Financial Statements and Supplementary Data of this document.

The following table sets forth: (i) Revenues, (ii) Expenses and (iii) Income from continuing operations before income taxes (Pre-Tax Earnings) of our segments and on a consolidated basis (in millions):

	For the years ended December 31,		
	2007	**2006**	**2005**
Asset Management			
Revenues	$ 118.2	$ 214.9	$ 89.8
Expenses	101.7	140.0	69.0
Pre-Tax Earnings	16.5	74.8	20.8
Global Markets			
Revenues	751.4	674.8	470.9
Expenses	571.1	524.5	435.8
Pre-Tax Earnings	180.4	150.3	35.1
Corporate			
Revenues	35.7	66.6	74.2
Expenses	31.3	35.3	24.9

Pre-Tax Earnings	4.3	31.4	49.3
Consolidated			
Revenues	905.3	956.3	634.8
Expenses	704.1	699.8	529.7
Pre-Tax Earnings	$ 201.2	$ 256.5	$ 105.2

Totals may not add due to rounding

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Asset Management Segment

Business Segment Overview

We operate an Asset Management business through our majority-owned Deephaven subsidiary. Deephaven is the registered investment manager and sponsor of certain private, unregistered funds commonly referred to as hedge funds (the Deephaven Funds). Generally, hedge funds are defined as pools of capital that may invest in any asset class, including derivatives, and may use long and short positions, derivative instruments, and leverage in order to generate returns for investors. A distinguishing feature of hedge funds is their use of long or short positions to seek to offset market risks and isolate arbitrage opportunities. Deephaven is based in Minnetonka, MN, and also has offices in London and Hong Kong.

Below is a summary of our assets under management at December 31, 2007, 2006 and 2005, and the blended fund returns for each of the years then ended:

	2007	2006	2005
Year-end assets under management (billions)	$ 3.9	$ 4.2	$ 2.9
Annual fund return to investors*	6.8%	22.8%	7.2%

* Annual fund return represents the blended annual return across all assets under management.

We earn fees from managing the Deephaven Funds, which consist of management fees, calculated as fixed percentages of assets under management, and incentive allocation fees, which, in general, are calculated as a percentage of the funds annual profits, if any.

Business Segment Structure

In 2003, the Company entered into long-term employment contracts with certain senior managers of Deephaven. These employment agreements, which became effective on January 1, 2004, had a three-year term which expired on December 31, 2006. The agreements provided for profit sharing bonuses based on the financial performance of Deephaven, which, for 2005 and 2006, represented 50% of pre-tax earnings prior to the profit-sharing bonuses. The employment agreements also included an option for renewal by the Deephaven managers through 2009 under identical financial terms; however, the renewal option was not exercised.

In December 2006, the Company entered into new long-term employment agreements (the 2006 Employment Agreements) with three senior managers of Deephaven (the Deephaven Managers), two of whom were parties to the agreements entered into in 2003. The 2006 Employment Agreements, which became effective on January 1, 2007, were for three-year terms and included a right of renewal by the Deephaven Managers through 2012 under certain circumstances. The 2006 Employment Agreements provided profit-sharing bonuses based on the financial performance of Deephaven. According to the terms of the 2006 Employment Agreements, the Deephaven Managers were entitled to receive 50% of the first $60 million, and 75% thereafter, of pre-tax earnings prior to the profit-sharing bonuses. Upon entering the 2006 Employment Agreements, the Deephaven Managers received one million shares of Knight restricted common stock, which vest ratably over three years.

In connection with entering into the 2006 Employment Agreements, the Deephaven Managers were granted an option (the Option) to obtain a 49% interest in a new limited liability company (Deephaven Holdings) to which our interests in Deephaven would be contributed. The Option became exercisable after January 1, 2008 upon Deephaven having met certain requirements regarding minimum assets under management and employee retention.

On January 10, 2008, Deephaven Managing Partners, LLC (Deephaven Partners), an entity owned and controlled by the Deephaven Managers, provided notice to the Company that it was exercising the Option.

On February 1, 2008, after regulatory and contractual approvals were received, the Company completed the transaction whereby the Company contributed its interest in Deephaven to Deephaven Holdings and Deephaven Partners acquired a 49% interest in Deephaven Holdings in exchange for the termination of the Deephaven Managers 2006 Employment Agreements and associated profit sharing bonuses and an equity contribution of $1 million to Deephaven Holdings by Deephaven Partners (the Deephaven Transaction). The Deephaven Transaction did not affect or result in any change to Deephaven s role as investment manager to the funds it currently manages or to the manner in which Deephaven carries out its duties as investment manager to those funds.

As part of the Deephaven Transaction, the Company and Deephaven Partners entered into a new Limited Liability Company Agreement (the New LLC Agreement) for Deephaven Holdings. In addition, the 2006 Employment Agreements terminated and were replaced by new long-term employment agreements between Deephaven Holdings and each of the Deephaven Managers (the New Employment Agreements). The New Employment Agreements do not include the profit-sharing bonuses provided for under the 2006 Employment Agreements; however, the Deephaven Managers continue to be entitled to participate in certain profit pools relating to specific Deephaven funds. Following the Deephaven Transaction, pre-tax earnings will be allocated between the Company and, through Deephaven Partners, the Deephaven Managers in a similar manner as under the 2006 Employment Agreements. Profit-sharing bonuses under the 2006 Employment Agreements had been reported in Employee compensation and benefits on our Consolidated Statements of Operations. As a result of the Deephaven Transaction, beginning in February 2008, profits or losses that are allocated to the Deephaven Managers will instead be reported as Minority interest on our Consolidated Statements of Operations and included as Minority interest on our Consolidated Statements of Financial Condition.

Under the New LLC Agreement, we own 51% of the shares in Deephaven Holdings, and Deephaven Partners owns 49% of the shares. As previously disclosed by us in a Form 8-K filing dated December 22, 2006, and subsequent regulatory filings, in the event of a change of control of the Company prior to December 31, 2012, Deephaven Partners will have the option (the Change of Control Option) to increase its 49% interest by an additional 2%. Upon any exercise of the Change of Control Option, we will be obligated to transfer ownership of 2% of the shares to Deephaven Partners. We are entitled to appoint a majority of the Board of Managers of Deephaven Holdings until such time as the Change of Control Option is exercised, at which time Deephaven Partners will be entitled to appoint a majority of the Board of Managers.

Under the New LLC Agreement, certain corporate actions will require approval of a super-majority of members of the Board of Managers, including representatives of both Deephaven Partners and us. Neither party is permitted to transfer any of its interests in Deephaven Holdings to any unaffiliated third person without the consent of the other party. Any sale of Deephaven Holdings requires either (x) the consent of the holders of 75% of the shares or (y) if the aggregate consideration is in excess of $450 million, the approval of only Deephaven Partners (subject to a right of first refusal for the benefit of the Company). Pursuant to the New LLC Agreement, proceeds from any sale or liquidation of Deephaven or Deephaven Holdings will be allocated among the Company and Deephaven Partners based upon a formula that takes into account their capital accounts at the time of such sale or liquidation and relative profit sharing percentages over a defined period of time.

Clients and Products

Investors in the Deephaven Funds include banks, insurance companies, funds-of-hedge funds, corporate and public pension plan sponsors, trusts, endowments and private clients. We differentiate ourselves based on our reputation, client relationships, experience of the management team, investment strategies, risk profile and historical fund returns. Included within Deephaven s $3.9 billion of assets under management as of December 31, 2007 is a corporate investment as a limited partner or non-managing member of $83.7 million held by the Company and $77.4 million of investments held by employee deferred compensation plans and certain officers, directors and employees of the Company. As of December 31, 2007, one investor accounted for more than 10% of the Deephaven Funds assets under management.

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As of December 31, 2007, approximately 58% of the Deephaven Funds assets under management were in the Global Multi-Strategy Fund (GMS Fund), formerly known as the Deephaven Market Neutral Fund. The investment philosophy for the GMS Fund is to seek to produce returns for its investors using various investment strategies focusing on delivering attractive risk-adjusted rates of return. The performance of the GMS Fund is intended to be substantially non-correlated with the general debt and equity markets, as well as with a number of other non-traditional investment strategies. Within the GMS Fund, Deephaven generally employs a variety of investment strategies, including volatility-driven, fundamental equity, event-driven, credit-driven and global relative value macro/fixed income strategies, among others. There is no material limitation on the types of investment strategies that may be employed by the GMS Fund.

In the second quarter of 2004, Deephaven launched a new single-strategy fund, the Deephaven Event Fund (Event Fund) which, as of December 31, 2007, held approximately $781 million in assets under management, or approximately 20% of the Deephaven Fund s assets under management. On January 31, 2008, Deephaven announced that it had concluded that it is in the best interests of investors in the Event Fund that the Event Fund return investors capital. The decision to return investors capital in the Event Fund occurred after a review by Deephaven of the Event Fund and the Event Fund s viability given the current macro-economic environment, performance over the preceding nine months, declining investor interest in event-driven investment strategies and significant levels of redemption requests in the Event Fund. Substantive changes in macro-economic circumstances in the U.S. have resulted in a reduction in the types of opportunities that Deephaven would ordinarily pursue as components of the Event Fund s core event-driven strategy and the conclusion that the Event Fund s core investment strategy is unlikely to produce the type of investment results Deephaven and its investors might expect over the short and intermediate term. As a result, redemptions in the Event Fund were suspended with immediate effect, and Deephaven began an orderly process to reduce trading positions to cash and return investors capital as promptly as reasonably practicable. Beginning February 1, 2008, and through the period of time Deephaven is returning investors capital, no management or incentive allocation fee will be charged to investors in the Event Fund.

Deephaven also manages other single-strategy funds as well as several separately managed accounts for institutional investors. As of December 31, 2007, these single-strategy funds and all separately managed accounts had, in aggregate, approximately $866.0 million, or approximately 22%, of the Deephaven Funds assets under management as of such date.

In order to offer additional product choices for its investor base, Deephaven may, in the future, look to increase the number of single-strategy funds it manages. Deephaven is continuing to increase the allocation of its assets under management invested in Europe and Asia.

Asset Management Competition

Deephaven competes primarily with other asset management companies that manage and sponsor multi-strategy, credit-driven, long short equity, event-driven and volatility-driven portfolios. As Deephaven launches new single strategy funds, it will compete with other asset management companies with similar investment strategies. Competition is primarily based on reputation, client relationships, the experience of the management team, investment strategies, risk profile, global presence, fee structures and historical fund returns. We believe that Deephaven s status as a voluntary SEC-registered investment adviser also differentiates its product offering and may enable Deephaven to attract additional assets under management from investors who previously would not invest in hedge funds managed by non-registered investment advisers.

There has been an on-going trend among fund management companies and institutions to allocate more of their assets to hedge fund investments. This has influenced the growth of the hedge fund industry, as shown in the table below. The continued growth of the hedge fund industry may provide for greater competition in the future.

	Estimated number of hedge funds	Estimated total assets under management (millions)
1990	610	$ 38,910
1995	2,383	185,750
2000	3,873	490,580
2005	8,661	1,105,385
2006	9,462	1,464,526
2007	10,096	1,868,419

Source: Hedge Fund Research, Inc. 2007 Industry Report

Asset Management Infrastructure

In managing the Deephaven Funds, Deephaven uses both an in-house developed proprietary order management system and a third-party portfolio management system. Deephaven has business continuity capabilities in place in the event it is unable to access or operate in its current locations.

Global Markets Segment

Business Segment Overview

We provide market access and trade execution services in nearly every U.S. equity security and a large number of international securities, futures, options, foreign exchange and fixed income. We offer high quality trade executions through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support alpha creation and capital formation. Our hybrid market model features an array of electronic and voice services that allow buy- and sell-side clients to connect with the market based on their specific needs and preferences. This model allows us to attract a larger base of clients with diverse investment styles and strategies, while at the same time, capture greater share of client order flow. To do so, the model requires that we manage risk and deploy capital effectively as well as maintain efficient and reliable trading technology. Substantially all of our Global Markets revenues and profitability come from our operations in the U.S.

The majority of our Global Markets revenue comes from making markets and providing market access and trade execution services in U.S. equities. Generally, market-makers display the prices at which they are willing to bid, meaning buy, or offer, meaning sell, securities and adjust their bid and offer prices in response to the forces of supply and demand for each security. As a market-maker operating in NASDAQ, the over-the-counter (OTC) market for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) listed securities, and the OTC Bulletin Board, we provide trade executions by offering to buy securities from, or sell securities to, institutions and broker-dealers. When acting as principal, we commit our own capital and derive revenues from the difference between the price paid when securities are bought and the price received when those securities are sold. We conduct the vast majority of market making activity as principal, through the use of automated quantitative models. Additionally, our traders offer execution services for complex trades and a variety of order types. We also provide trade executions on an agency or riskless principal basis, generating commissions or commission equivalents, respectively.

Our domestic Global Markets activities are primarily transacted out of five subsidiaries, Knight Equity Markets, L.P. (KEM), Knight Capital Markets LLC (KCM), Direct Trading Institutional, L.P. (Direct Trading), Hotspot FX, Inc. and its subsidiaries (Hotspot) and Knight BondPoint, Inc. (Knight BondPoint ,

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formerly known as ValuBond Securities, Inc.). KEM, KCM, Direct Trading and Knight BondPoint are broker-dealers registered with the SEC and members of the Financial Industry Regulatory Authority (FINRA), formerly known as the National Association of Security Dealers (NASD). Knight BondPoint is also registered with the Municipal Securities Rulemaking Board (MSRB). One Hotspot subsidiary is regulated by the U.K. Financial Services Authority (FSA) and another Hotspot subsidiary is a Futures Commission Merchant (FCM) registered with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA).

Our international Global Markets activities are primarily operated through Knight Equity Markets International Limited (KEMIL), a U.K. registered broker-dealer authorized and regulated by the FSA that provides execution services for predominately European institutional and broker-dealer clients in U.S., European and international equities. We intend to continue to expand our business and product offerings in Europe in 2008.

Over the past three years, we have completed the following acquisitions (and subsequent sale of an equity interest) of complementary businesses to strengthen our Global Markets business segment and expand and diversify our product offerings:

In June 2005, the Company acquired the business of Direct Trading, a privately held firm specializing in providing institutions with direct market access trading through an advanced electronic platform, now known as Knight Direct EMS . Upon the close of the transaction, the Company made a $40 million initial cash payment. The transaction also contained a two-year contingency from the date of closing for the payment of additional consideration based on the profitability of the business. In the third quarters of 2007 and 2006, the Company paid $10.4 million and $12.7 million, respectively, in additional cash consideration based on the profitability of the business during each of the first two years of operation after the closing of the acquisition.

In October 2005, the Company acquired the business of the ATTAIN ECN (now operating as Direct Edge ECN), an alternative trading system that operates an electronic communications network (ECN). The Direct Edge ECN provides a liquidity destination with the ability to match and route trades in NASDAQ, NYSE and AMEX listed securities by displaying orders in the NASDAQ Market Center, the FINRA Alternative Display Facility and the National Stock Exchange. The transaction closed with an initial cash payment and contained a four-year contingency from the date of closing for the payment of additional consideration based on meeting certain revenue and client retention metrics.

After the close of business on July 23, 2007 and September 28, 2007, Direct Edge Holdings LLC (Direct Edge Holdings), the parent company of Direct Edge ECN, issued equity interests to Citadel Derivatives Group LLC (Citadel) in exchange for cash. Immediately following the September 28, 2007 issuance to Citadel, the Company and Citadel sold a portion of their equity interests in Direct Edge Holdings to The Goldman Sachs Group, Inc. for cash. At the close of business on September 28, 2007 the Company deconsolidated Direct Edge Holdings as it no longer controlled Direct Edge Holdings as of that date. With the exception of the minority interest, the results of Direct Edge ECN operations have been included in the Consolidated Statements of Operations for all periods presented up to September 28, 2007. The Company accounts for its interest in Direct Edge Holdings under the equity method for periods subsequent to September 28, 2007.

In April 2006, the Company acquired, for $77.5 million in cash, Hotspot, an electronic foreign exchange marketplace that provides access to electronic foreign exchange spot trade executions through an advanced ECN-based platform.

In October 2006, the Company acquired, for $18.2 million in cash, Knight BondPoint, a privately held firm that provides electronic access and trade execution products for the fixed income market.

In November 2007, the Company announced the acquisition of EdgeTrade Inc. (EdgeTrade). On January 14, 2008, the Company completed the acquisition for $59.5 million comprising $29.5 million of cash and approximately 2.3 million shares of unregistered Company stock. EdgeTrade provides agency-only trade execution and algorithmic software to clients.

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Clients and Products

Clients

Within Global Markets, we offer products and provide services via electronic and voice access points primarily to two main client groups: sell-side (also referred to as broker-dealers) and buy-side (also referred to as institutions). Our sell-side clients include global, national and regional broker-dealers and on-line brokers. Our buy-side clients include mutual funds, pension plans, plan sponsors, hedge funds, trusts and endowments. Based on our internal allocation methodologies, our institutional clients (which include our direct market access, soft dollar and commission recapture clients) and our broker-dealer clients (which include our Direct Edge ECN clients through September 28, 2007) generated approximately 45% and 55%, respectively, of our Global Markets revenues in 2007.

In 2007, our Global Markets business did not have any client that accounted for more than 10% of our U.S. equity dollar value traded.

Products and Services

Our strategy for our Global Markets segment is to continue to differentiate ourselves from competitors by providing high quality and competitive trade execution services with superior client service. Over the past three years, we have worked to aggressively expand our product offering.

To our buy-side clients, we offer comprehensive, unbundled trade execution services covering the depth and breadth of the market. We handle large, complex trades, accessing liquidity from our order flow as well as other sources. When liquidity is not naturally present in the market, we offer capital facilitation to complete our clients trades. Our institutional products include equity, futures, options and foreign currency trade execution solutions, block trading, program trading, international equities, special situations/risk arbitrage, soft dollar and commission recapture programs through Donaldson & Co. (Donaldson), corporate access services, direct market access through Knight Direct EMS , internal crossing networks through our Knight Match product and algorithms through EdgeTrade. The majority of our revenues from institutional clients are commissions on agency transactions or commission-equivalents on riskless principal transactions.

We seek to provide sell-side clients with high quality and competitive trade executions that enable them to satisfy their fiduciary obligations to their customers to seek and obtain the best execution reasonably available in the marketplace. Most of our equity order flow comes from providing market-making and execution services to our broker-dealer clients through our electronic trading platform. Additionally, our traders offer execution services for complex trades and a variety of order types. We execute the majority of the order flow with these clients as principal through the use of our automated quantitative models. The majority of the revenues we earn from broker-dealer clients are net trading revenues, generated from the difference between the price paid when securities are bought and the price received when those securities are sold. We also provide fixed income and foreign currency trade executions to our broker-dealers clients.

Global Markets Competition

The securities industry is constantly evolving and intensely competitive, a trend that we expect will continue. Our market-making product competes primarily with similar products offered by both domestic and international broker-dealers, exchanges, alternative trading systems, crossing networks, ECNs and dark liquidity pools. We have also experienced greater competition from market-making firms with highly automated, electronic trading models. Another source of competition is broker-dealers who execute portions of their client flow through internal market-making desks rather than sending the client flow to third party execution destinations, such as Knight.

We compete primarily on the basis of our execution standards (including price, liquidity, speed and other client-defined measures), client relationships, client service, payments for order flow and technology. Over the past several years, regulatory changes, competition and the continued focus by regulators and investors on execution quality and overall transaction costs have resulted in a market environment characterized by narrowed spreads and reduced revenue capture metrics. Consequently, maintaining profitability has become extremely difficult for many market-makers. Generally, improvements in execution quality, such as faster execution speed and greater price improvement, negatively impact the ability to derive revenues from executing broker-dealer order flow. For example, we have made, and continue to make, changes to our execution protocols and quantitative models, which have had, or could have, a significant impact on our profitability. To remain profitable, some market-makers have limited or ceased activity in illiquid or marginally profitable securities or, conversely, have sought to execute a greater volume of trades at a lower cost by increasing the automation and efficiency of their operations. Beginning in the second quarter of 2005, we significantly increased the amount of automation in our market-making business by employing quantitative models and we now execute the vast majority of our trades on an automated basis through these models.

Competition for order flow in the U.S. equity markets continues to be intense as reflected in publicly disclosed execution metrics; i.e., SEC Rules 605 and 606. These rules, applicable to broker-dealers, add greater disclosure to execution quality and order-routing practices. Rule 605 requires market centers that trade national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. Rule 606 requires broker-dealers that route equity and option orders on behalf of their customers to make publicly available quarterly reports that describe their order routing practices and disclose the venues to which customer orders are routed for execution. These statistics on execution quality vary by order sender based on their mix of business. This rule also requires the disclosure of payment for order flow arrangements as well as internalization practices. The intent of this rule is to encourage routing of order flow to destinations based primarily on the demonstrable quality of executions at those destinations, supported by the order entry firms fiduciary obligations to seek to obtain best execution for their customers orders.

Commission rates have been under pressure for a number of years, and the ability to execute trades electronically through various competitive trading venues (including, both domestic and international broker-dealers, exchanges, alternative trading systems, crossing networks, ECNs and dark liquidity pools) has increased the pressure on trading commissions. We believe the trend toward increased competition and the growth of these and other alternative trading venues will continue. We may experience competitive pressures in these and other areas in the future as some of our competitors seek to obtain greater market share by reducing prices. Competition for business from institutional clients is based on a variety of factors, including execution quality, equity research, reputation, soft dollar and commission recapture services, technology, client relationships, client service, cost and capital facilitation.

Another factor contributing to the increase in competition for order flow is the significant mergers among U.S. market centers over the past several years, and the launch of independent ECNs, dark liquidity pools and joint ventures with regional stock exchanges. The effects of these mergers and the launch of new competition and liquidity sources, as well as the expected consolidation of certain U.S. and international stock exchanges, will be seen in the coming years.

Global Markets Infrastructure

We have invested significant resources to expand our execution capacity and upgrade our trading systems and infrastructure and plan to make additional investments in technology in the future. Our ability to identify and deploy emerging technologies that facilitate the execution of trades, including developing and enhancing our quantitative models, is key to the successful execution of our business model. Technology has enhanced our capacity and ability to handle order flow faster and also has been an important component of our strategy to comply with government regulations, achieve competitive execution standards, increase trading automation and provide superior client service. In 2005, we automated the majority of our execution services for broker-dealer order flow through our internally developed quantitative models, which contributed to the improvement of Global Markets financial results. We continually enhance our use of technology and quantitative models to further refine our execution services.

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We use our proprietary technology and technology licensed from third parties to execute trades, monitor the performance of our traders, assess our inventory positions, manage risk and provide ongoing information to our clients. We are electronically linked to institutions and broker-dealers to provide immediate access to our trading operations and to facilitate the handling of client orders. Our business-to-business portal, along with our Knight BondPoint, Hotspot, and Knight Direct EMS platforms, provide our clients with an array of tools to interact with our Global Markets trading systems, marketplaces, and most U.S. equity, futures and options market centers.

Alternative trading and data center facilities are in place for our primary domestic Global Markets operations. These facilities have been designed to allow us to continue a substantial portion of our operations if we are prevented from accessing or utilizing our primary office locations for an extended period of time.

Corporate Segment

Our corporate segment includes all costs not associated with our two operating business segments, primarily corporate overhead expenses. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses relating to corporate matters, directors fees, investor and public relations expenses and directors and officers insurance. This segment also includes the investment income earned on our strategic investments and our corporate investment as a limited partner or non-managing member in the Deephaven Funds. The results from our Corporate segment for 2005 and 2006 were positively impacted by realized gains from the sales of our strategic equity investments in the International Securities Exchange, Inc. (ISE) and the NASDAQ Stock Market, Inc. and for 2007 by gains related to the deconsolidation and partial sale of equity interests in Direct Edge ECN.

Intellectual Property and Other Proprietary Rights

Our success and ability to compete are dependent to a degree on our intellectual property, which includes our proprietary technology, trade secrets and client base. We rely primarily on trade secret, trademark, domain name, patent and contract law to protect our intellectual property. It is our policy to enter into confidentiality, intellectual property ownership and/or non-competition agreements with our employees, independent contractors and business partners, and to control access to and distribution of our intellectual property.

Government Regulation and Market Structure

Most aspects of the Company s business are subject to extensive securities regulation under federal, state and international laws. The SEC, FINRA, FSA, CFTC, MSRB, NFA, other self-regulatory organizations (commonly known as SROs), and other regulatory bodies, such as state securities commissions, promulgate numerous rules and regulations. As a matter of public policy, regulatory bodies are charged with safeguarding the integrity of the securities and other financial markets and with protecting the interests of investors in those markets. Regulated entities are subject to regulations concerning all aspects of their business, including trade practices, best execution practices, capital structure, record retention and the conduct of officers, supervisors and registered employees. Failure to comply with any of these laws, rules or regulations could result in administrative or court proceedings, censures, fines, the issuance of cease-and-desist orders or injunctions, or the suspension or disqualification of the entity and/or its officers, supervisors or registered employees. We, and certain of our past and present officers, directors and employees, have in the past been subject to claims alleging the violation of such laws, rules and regulations. We are currently subject to several of these matters as further described in Part I, Item 3, Legal Proceedings herein. Certain aspects of the Company s public disclosure, corporate governance principles, internal control environment and the roles of auditors and counsel are subject to the Sarbanes-Oxley Act of 2002 and related regulations and rules of the SEC and NASDAQ.

Rule-making by the SEC, FINRA, FSA, CFTC, MSRB and NFA and corresponding market structure changes, can have, and have had an impact on the Company s regulated subsidiaries by directly affecting our

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method of operation and profitability. Legislation such as the USA PATRIOT Act of 2001 has imposed significant obligations on broker-dealers and mutual funds. These increased obligations require the implementation and maintenance of internal practices, procedures and controls which have increased our costs and may subject us to regulatory inquiries, claims or penalties.

The regulatory environment in which we operate our Global Markets business segment is subject to constant change. Our business, financial condition and operating results may be adversely affected as a result of new or revised legislation or regulations imposed by the U.S. Congress, the SEC, CFTC, FSA, other United States or foreign governmental regulatory authorities, FINRA, MSRB, NFA and other regulatory bodies or SROs. Additional regulations, changes in existing laws and rules, or changes in interpretations or enforcement of existing laws and rules often directly affect the method of operation and profitability of regulated broker-dealers. We cannot predict what effect, if any, such changes might have. For example, in June 2005, the SEC adopted rules under Regulation NMS designed to modernize and strengthen the regulatory structure of the U.S. equity markets. Although adopted in 2005, Regulation NMS did not go into complete effect until October 2007. It is too soon to assess what the market structure implications will be from Regulation NMS. However, there were, and will continue to be, significant technological and compliance costs associated with the obligations which derive from compliance with this regulation. In addition, FINRA proposed rules regarding the OTC Bulletin Board markets which would require that all non-NASDAQ securities be subject to limit order protection.

The market structure in which the Global Markets business operates is rapidly changing. The recent expansion of many regional exchanges, in which several exchanges are seeking to create their own alternative trading systems (e.g., ECNs) and compete in the OTC and listed trading venues, as well as the consolidation of exchanges (e.g., NASDAQ s acquisition of the Boston and Philadelphia Stock Exchanges, as well as the NYSE s acquisition of the American Stock Exchange) and the global expansion of exchanges (e.g., NASDAQ and the OMX, and NYSE and Euronext), have altered the landscape of the marketplace.

We have foreign based subsidiaries and plan to expand our international presence. The brokerage industry in many foreign countries is heavily regulated, much like the U.S. The varying compliance requirements of these different regulatory jurisdictions and other factors may limit our ability to conduct business or expand internationally. For example, the Markets in Financial Instruments Directive (MiFID) adopted by the European Commission, was implemented in November 2007. MiFID represents one of the more significant changes to take place in the operation of European capital markets. It is possible that MiFID and its associated rules and directives could negatively impact our Global Markets business. Since MiFID did not go into effect until November 2007, it is too soon to assess what the market structure implications will be from MiFID. However, there were, and will continue to be, significant technological and compliance costs associated with the obligations which derive from compliance with this regulation.

Deephaven became registered as an investment adviser with the SEC in 2006. Registration as an investment adviser has resulted in additional regulatory responsibilities and obligations on Deephaven s business compared to those prior to registration and those applicable to unregistered investment advisers. Deephaven is also registered with the CFTC and is a member of the NFA as a commodity pool operator and a commodity trading adviser. Due to the nature of Deephaven s client base, however, Deephaven is exempt from many of the CFTC and NFA regulations. Deephaven s U.K. subsidiary is regulated by the FSA and Deephaven s Hong Kong subsidiary is regulated by the Hong Kong Securities and Futures Commission.

The Company believes that it is in material compliance with applicable regulations.

Net Capital Requirements

Certain of our subsidiaries are subject to the SEC s Net Capital Rule. This rule, which specifies minimum net capital requirements for registered broker-dealers, is designed to measure the general financial integrity and liquidity of a broker-dealer and requires that at least a minimum part of its assets be kept in relatively liquid

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form. In general, net capital is defined as net worth (assets minus liabilities), plus qualifying subordinated borrowings and certain discretionary liabilities, less certain mandatory deductions that result from excluding assets that are not readily convertible into cash and from valuing conservatively certain other assets. Among these deductions are adjustments, commonly called haircuts, which reflect the possibility of a decline in the market value of an asset before disposition, and non allowable assets.

Failure to maintain the required net capital may subject a firm to suspension or revocation of registration by the SEC, and suspension or expulsion by FINRA and other regulatory bodies, and ultimately could require the relevant entity s liquidation. The Net Capital Rule prohibits payments of dividends, redemption of stock, the prepayment of subordinated indebtedness and the making of any unsecured advance or loan to a stockholder, employee or affiliate, if such payment would reduce the firm s net capital below required levels.

A change in the Net Capital Rule, the imposition of new rules or any unusually large charges against net capital could limit those operations that require the intensive use of capital and also could restrict our ability to withdraw capital from our broker-dealer subsidiaries. A significant operating loss or any unusually large charge against net capital could adversely affect our ability to expand or even maintain our present levels of business.

Certain of our foreign subsidiaries are subject to capital adequacy requirements set by their respective regulators.

During 2007, all of our broker-dealer subsidiaries were in compliance with their capital adequacy requirements. For additional discussion related to net capital, see Footnote 21 Net Capital Requirements included in Part II, Item 8 Financial Statements and Supplementary Data of this document.

Employees

At December 31, 2007, our headcount was 868 full-time employees, compared to 844 full-time employees at December 31, 2006. The employee headcount at December 31, 2006, included 14 employees of Direct Edge ECN. The increase, exclusive of the Direct Edge ECN employees, in headcount is primarily related to expansion of our Asset Management and Global Markets offerings in 2007. Of our 868 full-time employees at December 31, 2007, 781 were employed in the U.S. and 87 outside the U.S., primarily in the United Kingdom. None of our employees is subject to a collective bargaining agreement. We believe that our relations with our employees are good.

Item 1A. ***Risks Factors***

We face a number of risks that may adversely affect our business, financial condition and operating results. These include, but are not limited to, the following: